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## India's Regulation of Direct Foreign Investment: Article 29 of the 1973 Foreign Exchange Regulation Act

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INDIA'S REGULATION OF DIRECT FOREIGN INVESTMENT:  
ARTICLE 29 OF THE 1973 FOREIGN EXCHANGE  
REGULATION ACT

INTRODUCTION

In theory, India's treatment of foreign investment has always been guided by the twin goals of industrialization and self-reliance. The foundations for India's investment policy were established shortly after Independence in a statement made by the late Prime Minister Nehru to the Constituent Assembly on April 6, 1949.<sup>1</sup> The key elements of the Nehru policy were the following: a) investment would be welcomed where it was in the national interest; b) once foreign investment had been approved, it would receive equal treatment with Indian companies; c) remittances of profits, dividends, interest, and full repatriation of capital would be freely allowed; and d) although nationalization was not contemplated, in such an event, fair and equitable compensation would be paid.<sup>2</sup>

Nehru's emphasis on the consideration of national priorities in the evaluation of foreign investment proposals was not

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<sup>1</sup> H. Singh, Foreign Investment Policy of India 1 (pamphlet published by the Indian Investment Centre, New York, 1979).

<sup>2</sup> Id., at 1-2.

realized in practice. Prior to the enactment of the Foreign Exchange Regulation Act (FERA) in 1973, little selectivity was exercised with respect to the approval of foreign investment proposals and little control was exercised over foreign enterprises after they had been established.

Article 29 of the 1973 Foreign Exchange Regulation Act<sup>3</sup> is the statutory basis of a new foreign investment policy which attempts to fill this void and ensure that investment will be permitted only where it is in accordance with developmental goals. The regulations issued pursuant to Article 29 by the Ministry of Industry, together with the "Industrial Policy Statements" issued by the Ministry of Finance, establish a regulatory framework for the evaluation of foreign investment and collaboration proposals and the treatment of existing foreign-owned enterprises.

The purpose of this new regulatory framework is actually a two-fold one: first, to eliminate the historic ill-effects of unregulated foreign investment;<sup>4</sup> second, to ensure the compatibility of foreign investment with national social and economic goals.

This article will examine the way in which Article 29 of the Foreign Exchange Regulation Act embodies India's new foreign investment policy. It will also study the implementation of the Act and the approval process for foreign investment in India. Finally, the article will offer a preliminary evaluation of the extent to which India's stated policy goals have, in fact, been achieved.

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<sup>3</sup>Effective, January 1, 1974.

<sup>4</sup>E.g., the draining of foreign exchange reserves through high profit remittances, import policies, and transfer pricing; the production of inappropriate products; displacement of local enterprises and increased unemployment; and the creation of technological dependence. See, e.g., Shankar, The Performance of Transnational Corporations in India, 33 INDIA Q. 181, 188 (1977).

## Economic and Social Goals

India faces an enormous development task. Almost one-half of its population of 660 million lives below the poverty line.<sup>5</sup> Although India's GNP ranks 15th in the world, per capita income is only about \$180 U.S. dollars, which places it among the poorest countries.<sup>6</sup> Unemployment and underemployment are the country's chief economic problems.

The creation of job opportunities is therefore a key goal for Indian economic planners. Expansion of the industrial sector was once viewed hopefully as a source of new employment opportunities.<sup>7</sup> These expectations have not been realized. Despite India's rapid industrialization, the industrial sector still employs only 9.7% of the workforce.<sup>8</sup> The overwhelming majority of the working population remains in the traditional agricultural sector where underemployment is a major problem. The lag in the production of jobs is due primarily to the capital-intensive nature of modern production methods. The tension between efficiencies of production and the creation of jobs is expected to remain a continuing problem for Indian economic planners.<sup>9</sup>

Self-reliance and import substitution are also key economic goals. Since the introduction of the first Five-Year (development) Plan in 1951, India has aimed at achieving self-sufficiency in such basic industrial sectors as steel,

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<sup>5</sup> Krishna, The Economic Development of India, SCIENTIFIC AM., Sept., 1980, at 166, 169. Poor households are defined as those having a per capita monthly consumption of less than 65 rupees (\$8 U.S. dollars) in rural areas or 75 rupees (\$9 U.S. dollars) in urban areas. Id.

<sup>6</sup> Id., at 172.

<sup>7</sup> F.FRANKEL, INDIA'S POLITICAL ECONOMY, 1947-1977, at 495 (1978).

<sup>8</sup> Id.

<sup>9</sup> Kurien, The New Development Strategy, ECON. & POL. WEEKLY (Bombay), August, 1978, at 1257.

tools, machinery, fertilizers, transportation equipment, and chemicals.<sup>10</sup> Although the import substitution policy has met with considerable success,<sup>11</sup> further development of indigenous capacity is still required in many basic industrial sectors in order to achieve self-sufficiency. Fertilizers, heavy chemicals, scientific instruments, iron and steel, and electrical machinery are a few of the many areas in which domestic production is inadequate.<sup>12</sup> A basic aim of the FERA legislation, therefore, is to channel the financial and technological resources of foreign investors into sectors in which existing production is inadequate, thereby encouraging import substitution and industrial development.<sup>13</sup>

Import substitution is vital not only for the achievement of self-reliance, but also for the preservation of scarce foreign exchange reserves. Foreign exchange is needed for the import of the capital goods, technology, and raw materials necessary to maintain and diversify industrial development.<sup>14</sup> A shortage of foreign exchange cripples industrial development by depriving it of these basic factors.<sup>15</sup> India, like many developing countries, suffers from a chronic shortage of foreign exchange.<sup>16</sup> Although import substitution and strict

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<sup>10</sup> Krishna, supra note 5, at 166.

<sup>11</sup> Between 1955-1978, imports fell to 2-21% of total supply in 21 industrial sectors. Id. See also Kelkar, India and World Economy, ECON. & POL. WEEKLY (Bombay) Feb., 1980, at 246, 249 and V. MAHAJAN, PLANNING, DEVELOPMENT, AND ECONOMIC POLICY IN INDIA 100-101 (1974) (charting import substitution in 14 product groups for years 1950-1969).

<sup>12</sup> Export Fetishism, ECON. & POL. WEEKLY, (Bombay), August, 1980, at 1257.

<sup>13</sup> See, "Industrial Sector Restrictions", p. 78 infra.

<sup>14</sup> Krishnaswamy, Foreign Exchange Management in India and the Philippines, INDIAN J. PUB. AFF., Jan.-Mar., 1980, at 21, 22.

<sup>15</sup> Id.

<sup>16</sup> Developing economies require massive imports of basic materials. These imports are generally not offset by export earnings because the export sector remains undeveloped. Id.

import controls made some progress towards alleviating this situation in the 1960's, rising oil prices during the last decade have considerably worsened India's balance of payments deficit. Petroleum products now form nearly 70% of India's total import bill.<sup>17</sup> Due to rising oil prices, India's balance of payments deficit is expected to reach a record 50 billion rupees (about \$6.7 billion U.S. dollars) for the fiscal year 1980-81.<sup>18 & 19</sup>

The preservation of foreign exchange reserves will be of continuing importance to Indian economic planners. Import substitution and export promotion will play a key role in this effort.<sup>20</sup> Import substitution and export promotion, however, are both dependent on the process of industrialization, which, in turn, requires the rapid development of indigenous technology. A major concern of the FERA regulations, therefore, is to ensure the transfer and absorption of new technology on terms which will be fair to both parties.<sup>21</sup>

#### The Foreign Exchange Regulation Act - Article 29

The express purpose of the 1973 Foreign Exchange Regulation Act (FERA) is to regulate the flow of foreign

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<sup>17</sup> The Statesman (New Delhi), Jan. 18, 1981, at 1, col. 2.

<sup>18</sup> The Statesman (New Delhi), Jan. 17, 1981, at 1, col 1.

<sup>19</sup> Substantial government funds have been committed for the development of coal, gas, and oil reserves in 1980-18. Indian Budget to Revive Economy, ECON. NEWS DIG., July-Aug., 1980, at 1 (published by the Indian Investment Centre, New York). India has large coal supplies, though of a relatively low quality, and only a modest supply of oil. R. PARK & B. DE MESQUITA, INDIA'S POLITICAL SYSTEM, (2d ed., 1979).

<sup>20</sup> See e.g., 1980-81 Budget Speech of Finance Minister, R. Venkatraman, reprinted in, ECON. NEWS DIG., July-Aug. 1980, at 1, (citing "critical role of exports and announcing plan to encourage exports through the establishment of an Export-Import Bank).

<sup>21</sup> See "Technological Collaborations", pp. 73-74 infra.

exchange.<sup>22</sup> The provisions of the Act attempt to reach a wide variety of practices (e.g., smuggling, remittances abroad by private individuals) which affect the outflow of foreign exchange. Foreign investment is only one of the many areas of economic life which this statute addresses.

Only Article 29 of FERA is concerned with the regulation of direct foreign investment. Under Article 29, "foreign enterprises" and foreign individuals are required to obtain the permission of the Reserve Bank of India in order to continue, establish, purchase shares in, or acquire, wholly or partly, equity in any commercial or industrial enterprise in India.<sup>22a</sup>

The draining of the foreign exchange reserves was one of the chief evils associated with the operations of multinational corporations in India prior to the FERA regulations.<sup>23</sup> While classical development theory viewed foreign investment as a supplement to foreign exchange receipts,<sup>24</sup> studies undertaken by the Reserve Bank of India (R.B.I.) and by private individuals, showed that, in practice, the operations of private investors had a negative impact on foreign exchange

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<sup>22</sup>The purpose of the Act, as stated in its preamble is: to consolidate and amend the law regulating certain payments, dealings in foreign exchange and securities, transactions indirectly affecting foreign exchange and the import and export of currency and bullion, for the conservation of the foreign exchange resources of the country and the proper utilisation thereof in the interests of the economic development of the country. Chaudhuri, FERA: Appearances and Reality, ECON. & POL. WEEKLY (Bombay), April 21, 1979, at 734.

<sup>22a</sup> Id., (citing Foreign Exchange Regulations Act, § 29(1), p. 18 (Delhi 1975)).

<sup>23</sup>See, e.g., Shankar, supra note 4, at 188-189.

<sup>24</sup>See, e.g., the discussion in, First and Third World Linkages, 34 INT'L ORGANIZATION 41 (1980).

earnings.<sup>25 & 26</sup>

The drain on foreign exchange was chiefly caused by high profit remittances, license fees, and royalty payments.<sup>27</sup> Sometimes profit remittances were disguised in the form of transfer or salary payments.<sup>28</sup> Imports of goods and machinery from parent companies abroad also contributed to the drain on foreign reserves.<sup>29 & 30</sup>

Article 29 does not itself place any restrictions on foreign investors or contain any guidelines concerning the regulation of foreign investment. Guidelines for the enforcement of Article 29 were issued by the Ministry of Industry in December of 1973 and later modified in April of 1976. These guidelines apply both to companies already operating in India and to prospective investors.

The FERA guidelines attempt to achieve a variety of goals in addition to the expressed purpose of the Act, the control

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<sup>25</sup> E.g., one RBI study for the period 1964-70 showed an outflow of Rs 19.822 billion compared with an inflow of Rs. 10.9 billion.

<sup>26</sup> The draining of foreign exchange reserves was among the charges levied against Coca-Cola and IBM during the Parliamentary hearings on the status of the two companies. Shankar, supra note 4, at 188.

<sup>27</sup> Id., at 188-189.

<sup>28</sup> See, e.g., Shankar, supra note 4, at 189, discussing remittances for illusory "head-office expenses" by the Grindlay's Bank. During the years 1966-71, expenses remitted amounted to Rs. 42.1 million while dividends remitted amounted to Rs. 58.8 million. See also, Chaudhuri, supra note 22, at 736 (discussing identical practice among British tea companies).

<sup>29</sup> A study of the operations of 20 US manufacturers in India showed that all had relied on imports from their parent companies and switched to local manufacture only when forced to do so by increasing import restrictions. A. Desai, U.S. Corporations as Investors in India, ECON & POL WEEKLY (Bombay), Dec. 8, 1979, at 2013.

<sup>30</sup> The draining of foreign exchange reserves through practices of this type is a typical problem associated with the operation of multinational corporations in developing countries. See, e.g., UNITED NATIONS, REPORT OF THE GROUP OF EMINENT PERSONS TO STUDY THE IMPACT OF MULTINATIONAL CORPORATIONS ON DEVELOPMENT AND ON INTERNATIONAL RELATIONS (1974) [hereinafter cited as U.N. GEP REPORT].



of foreign exchange.<sup>31</sup> The development of adequate indigenous capacity in basic industrial sectors is encouraged because of its importance to industrial development as well as its role in the preservation of foreign exchange. The guidelines also seek to support social goals such as "Indianization" and the reduction of economic inequities. "Indianization" is the transfer of corporate ownership and control to Indian nationals. The drive for "Indianization" is motivated by the desire for freedom from foreign influence and domination in national economic life. "Indianization" is also motivated by the desire for a broader distribution of wealth among the Indian population.<sup>32</sup> The reduction of economic disparities is a long-term goal of Indian planning.<sup>33</sup>

The regulatory framework formed by the FERA guidelines may be roughly divided into three categories: 1) restrictions on the terms of technical collaborations; 2) equity restrictions; and 3) industrial sector restrictions. Of these three categories of regulations, those concerning the terms of technology transfer agreements deserve first consideration because of the centrality of the transfer of technology to developmental goals and to India's concept of the role of foreign investment.

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<sup>31</sup> See, Chadhuri, supra note 22, at 7.

<sup>32</sup> This is achieved in practice by governmental preference for large public offerings which distribute stock to many thousand small investors rather than to a few institutional investors. See, "The Implementation of FERA," p. 85 infra.

<sup>33</sup> The Indian Parliament voted in 1954 to adopt the "socialist pattern of society." The Industrial Policy Statement of 1956 reaffirmed this resolution and declared the reduction of social inequities and economic concentration to be "urgent" goals. Industrial Policy Statement (April 30, 1956) reprinted in, MAHAJAN, supra note 11, 152-154. The development of a socialist society and the reduction of economic inequality have remained accepted goals. PARK & DE MESQUITA, supra note 19, at 53.

Technological Collaborations

India views foreign investment primarily as a vehicle for the transfer of technology rather than as a source of additional investment capital.<sup>34</sup> India's investment capital is derived almost entirely from internal funding (through taxation and deficit financing) and from domestic savings.<sup>35</sup> Foreign assistance has been marginal in comparison with internal investment.<sup>36</sup>

The Government of India prefers outright purchases of technology to those accompanied by an equity interest or royalty arrangement.<sup>37</sup> This preference reflects the desire for economic autonomy and the need to contain the outflow of foreign exchange which results from dividend and royalty payments. Financial investment is allowed, however, where the technology in question cannot be readily acquired elsewhere by outright purchase.<sup>38</sup> In no event is foreign investment permitted without an accompanying transfer of technology or know-

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<sup>34</sup> H. Singh, supra note 1, at 4. See also, Krishnaswamy, supra note 14, at 28. Krishnaswamy traces a change in the conception of the role of foreign investment since the early 1950's. He writes that, in the 1950's, foreign investment changed from a supplement to domestic savings to a supplement to foreign exchange receipts. In the 1960's, foreign investment came to be viewed as a tool for bridging the technological gap. Since then, the conception has changed again. Foreign investment is now viewed exclusively as a vehicle for the transfer of technology which cannot be purchased outright.

<sup>35</sup> PARK & DE MESQUITA, supra note 19, at 55.

<sup>36</sup> Id.

<sup>37</sup> H. Singh, supra note 1, at 4; Krishnaswamy, supra note 14, at 28.

<sup>38</sup> Id. However, this is not the only factor involved in deciding whether to permit an equity investment. See, p. 83 infra, on the criteria employed in the evaluation process.

how.<sup>39</sup> (Foreign investors are therefore barred from such fields as banking, commerce, finance, and plantation and trading industries, where foreign technology is not necessary.)

Technology transfer agreements prior to the enactment of FERA frequently contained numerous restrictive clauses which limited their usefulness as a tool for the development of indigenous technology and industrialization.<sup>40</sup> Clauses which tied technology to imports from the parent company or which prohibited exports into the parent's "territory" were common and hampered the country's drive toward self-reliance and import substitution. Clauses forbidding sub-licensing were also common and thwarted attempts at assimilation of Western technologies. The technology transferred was often obsolete, thus creating a state of dependence on further transfers of technology. Finally, license fees and royalties were often so high that they drained the company of profits and the country of foreign exchange.

For these reasons, technology collaboration agreements under the new guidelines will now be strictly scrutinized. Lump sum payments are preferred, generally to be paid in installments, 1/3 on signing the agreement, 1/3 on transfer of documentation, etc., and 1/3 at the commencement of production.<sup>41</sup> Payments may also be made in the form of royalties or in a combination of a lump sum and a royalty.<sup>42</sup> Royalties are

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<sup>39</sup>This policy has recently been liberalized with respect to OPEC investors. OPEC investments are now permitted without transfer of technology, provided the investment is in a new enterprise within the "core" sector and does not exceed 40% of equity. The purpose of the liberalization is to recapture some of the foreign exchange India spends on the purchase of oil. Previously, OPEC investors had been effectively excluded from India because they had little technology to offer. THE ECONOMIC TIMES (Bombay) Oct. 29, 1980, at 1, col. 1.

<sup>40</sup>Kelkar, supra note 11, at 253.

<sup>41</sup>Guide to Investing and Licensing in India, (publication of the Indian Investment Centre, New York), at 37 [hereinafter cited as IIC Guide].

<sup>42</sup>H. Singh, supra note 1, at 7.

usually limited to 5% of the value of production, although higher royalties are sometimes allowed.<sup>43</sup>

Royalty agreements are normally limited to either five years from the commencement of production or eight years from the date of the agreement.<sup>44</sup> At the end of that period, an application for renewal or extension must be made. Renewals are generally allowed where the technology is not available from indigenous sources or where the collaboration is in an export-oriented enterprise.<sup>45</sup> Royalty payments and lump sum payments are both subject to Indian taxes. The tax on royalties is 40%, on lump sum payments, 20%.<sup>46</sup>

Technical collaboration agreements must also meet certain other guidelines set down by the government.<sup>47</sup> Agreements must be free of clauses which restrict the export activities of the enterprise. Any form of tying arrangement or restrictions on pricing and sales policy is frowned upon. In addition, the Indian party should be free to sub-license the technology on terms which will be mutually agreeable to all parties (including the government and the foreign licensor). Finally, in order to protect domestic producers from the superior competitive advantage of well-known foreign trade-marks, the government has prohibited the use of foreign trade-marks on any product intended for the domestic market.<sup>48</sup>

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<sup>43</sup>The level of foreign equity is taken into account in fixing the royalty fee in order to prevent the drain on foreign exchange reserves resulting from the combination of high royalty payments and large dividends. Id.

<sup>44</sup>Id.

<sup>45</sup>IIC Guide, supra note 41, at 37.

<sup>46</sup>Id.

<sup>47</sup>The list of standard conditions is contained in, IIC Guide, supra note 41, at 37.

<sup>48</sup>Id. Foreign trade-marks are permitted on goods intended for export.

## Equity Restrictions

Article 29 of FERA states that "foreign enterprises" and foreign individuals are required to obtain the permission of the Reserve Bank of India in order to continue to hold or to acquire equity in any commercial or industrial enterprise in India.<sup>49</sup> Under the FERA regulations, the term "foreign enterprises" includes subsidiaries of companies incorporated outside of India as well as Indian companies in which 40% or more of the equity is foreign-owned.<sup>50</sup>

Under the 1973 guidelines, foreign investment was limited to 40% of equity and permitted only in certain "core" sectors of national importance.<sup>51</sup> This rule was greatly liberalized by the amendments of 1976 which allowed greater foreign ownership for enterprises engaged in priority industries (e.g., electronics) involving the use of sophisticated technology and for export-oriented enterprises.<sup>52</sup>

Enterprises which export over 60% of their production are now allowed up to 74% foreign equity. Firms which employ sophisticated technology and whose output of priority products (for domestic use) exceeds 75% are allowed up to 74% foreign equity. Those whose combined exports and production of priority items is between 60% and 75% (with exports of at least 10%) are allowed 51% foreign equity. Finally, if a firm exports all of its production, 100% foreign ownership is

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<sup>49</sup>See, p. 70 supra.

<sup>50</sup>This last provision closes an important gap. Prior to FERA, companies incorporated in India, but controlled by foreigners, (so-called "rupee companies") were not recognized as foreign enterprises. Chaudhuri, supra note 22, at 735.

<sup>51</sup>In addition, the investment must be accompanied by a transfer of technology or know-how. See, p. 73 supra.

<sup>52</sup>BUSINESS INTERNATIONAL, II INVESTING, LICENSING & TRADING CONDITIONS ABROAD, (ASIA) 7 (1980) [hereinafter cited as BUS.INT'L].

permitted.<sup>53</sup>

The main purpose of the equity restrictions, as they applied to existing foreign-owned companies, was to effect the transfer of ownership to Indian nationals. The fear of economic domination by a handful of large multinational enterprises is probably a major motivation behind this goal.<sup>54</sup> Multinational enterprises are, generally speaking, more concerned with overall profits than with the economic and social goals of host countries.<sup>55</sup> Subsidiaries of such companies are often required to follow practices which benefit the parent company at the expense of both the subsidiary and the host country.<sup>56</sup> The FERA equity restrictions ensure that almost all enterprises operating in India will have some Indian ownership. It is hoped that this process of "Indianization" will result in greater consideration of local and national development goals.<sup>57</sup> "Indianization" should also aid in the conservation of foreign exchange by reducing the outflow of profit remit-

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<sup>53</sup> These regulations were intended to apply to companies already operating in India as well as to prospective investors. All foreign-owned enterprises were ordered to file for approval with the Reserve Bank. Companies which did not meet the above requirements were directed to reduce their foreign equity. On the implementation of these provisions, see p. 85 infra.

<sup>54</sup> The fear of economic domination by multinational corporations is common among developing countries, many of whom find the sheer size of these companies a threat to state autonomy. See e.g., U.N.GEP REPORT, supra, note 30. Exxon and General Motors, e.g., have sales figures in excess of the GNP's of many developing countries. This is not the case with India which has the 15th largest GNP in the world. However, one author has pointed out that 23 of the largest multinationals operating in India have sales figures in excess of the total annual government budget. Shankar, supra note 4, at 183-184.

<sup>55</sup> THE INDEPENDENT COMMISSION ON INTERNATIONAL DEVELOPMENT ISSUES: NORTH-SOUTH: A PROGRAMME FOR SURVIVAL 190 (1980) [hereinafter cited as BRANDT COMMISSION REPORT].

<sup>56</sup> Restrictions on the exports of the subsidiary and tied imports from the parent company are examples of such practices. Id., at 189.

<sup>57</sup> This result is unlikely to be achieved unless transfer of ownership leads to transfer of control. See, infra note 107 at 87.

tances and dividends to foreign investors.

### Industrial Sector Restrictions

In addition to the restrictions on equity, foreign investment will also be restricted to certain "core" industries of national importance.<sup>58</sup> The 1973 Industrial Policy Statement (IPS), issued by the Ministry of Finance, sets forth 19 industries to which foreign investment, as well as the activities of large domestic "investment houses", will be confined.<sup>59</sup> Included among the "core" industries listed by the 1973 IPS are chemicals and fertilizers, boilers and steam generating plants, scientific instruments, and the metallurgical industries.<sup>60</sup>

Foreign investment is not permitted in all of the 19 industrial groups listed. The list of industries in the 1973 IPS was adopted without amendment from the 1951 Industries (Development and Regulation) Act<sup>61</sup> and fails to exclude products which have since been reserved for the public sector<sup>62</sup> or for small-scale enterprises.<sup>63</sup>

The restrictions of the 1973 IPS were the outcome of a growing concern that the economy was becoming dominated by large domestic investment houses and multinational corporations. The background for the 1973 IPS was set by two

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<sup>58</sup> Exceptions may be available for firms which export all, or a substantial amount, of their production. BUS. INT'L., supra note 52, at 6.

<sup>59</sup> 1973 Industrial Policy Statement, reprinted in, MAHAJAN, supra note 11, at 172-177 [hereinafter cited as 1973 IPS].

<sup>60</sup> Id., at 176-177.

<sup>61</sup> Id., at 177.

<sup>62</sup> E.g., ship-building, iron and steel, and electrical transmission equipment. IIC Guide, supra note 41, at 9.

<sup>63</sup> Some 787 products have been reserved for the small-scale sector. Investment in these areas is possible only if production is predominantly for export. BUS. INT'L, supra note 52, at 5-6.

Parliamentary inquiries (the Hazari and Dutt inquiries) into the subject of economic concentration.<sup>64</sup> The findings of the Hazari and Dutt inquiries, in brief, were that the multinational corporations and Indian conglomerates, through a combination of superior production efficiencies and restrictive trade practices, often crowded out small enterprises or prevented them from entering the market.<sup>65</sup>

The results of these investigations led to the passage of the Monopolies and Restrictive Trade Practices Act<sup>66</sup> in 1969. Although the MRTP Act did not affect the existing status of the conglomerates, it required governmental approval of any future expansion by foreign-owned enterprises and "dominant" Indian companies.<sup>67</sup>

The confinement of foreign investment to core sector industries, which was imposed by the 1973 IPS, is a reflection of government concern for the protection and encouragement of indigenous small-scale enterprises. The 1973 IPS also reflects the government's determination to allow foreign investment only where it is in the national interest, i.e., only in those industries in which indigenous production is inadequate, technology undeveloped, and in which foreign investment will not displace existing domestic enterprises. Viewed in a more positive light, the restrictions are an attempt to channel the vast technological and financial resources of foreign investors into those areas in which they are most urgently needed.

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<sup>64</sup> ECON. & POL. WEEKLY (Bombay), July 21, 1979, at 1198.

<sup>65</sup> The "crowding-out" effect is a common consequence of the operations of multinational enterprises in developing countries. Superior technology enables the multinational to realize production efficiencies which local small-scale units cannot, thus driving them out of business. Because of the capital-intensive nature of the technology, the net effect is often an increase in local unemployment.

<sup>66</sup> Hereinafter cited as MRTP act.

<sup>67</sup> BUS. INT'L., supra note 52, at 9. See also, F. FRANKEL, supra note 7, at 436-439, (discussing the background of the MRTP legislation).



Foreign firms are generally excluded from industries not listed by the 1973 IPS. The government, however, recognizes the need to maintain up-to-date technology, and additional foreign investment will be allowed in these areas if it introduces needed new technology.<sup>68</sup> Foreign enterprises may also be accepted if their export commitment is substantial.<sup>69</sup>

The list of "core" industries contained in the 1973 IPS is subject to continuing scrutiny. The government regularly publishes lists of industries or product groups in which foreign investment is no longer considered necessary because existing needs are adequately met.<sup>70</sup> The Janata government recently drew up a list of 22 such product groups in which foreign investment is no longer considered necessary.<sup>71</sup> Prospective investment in these areas will be discouraged.<sup>72</sup>

One result of the 1973 IPS restrictions is the exclusion of foreign investors from the manufacture of consumer goods for the domestic market. The concentration of foreign investment in the area of consumer goods has provoked some of the most bitter criticism of the role of multinational enterprises. The complaint is a common one among developing countries.<sup>73</sup> Multinational enterprises were (and are) charged with producing goods which cater only to the tastes and financial resources of an elite few and are inappropriate to a

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<sup>68</sup> IIC Guide, supra note 41, at 33.

<sup>69</sup> BUS. INT'L., supra note 52, at 5.

<sup>70</sup> Id., at 7. However, the government is strongly committed to export promotion. Exceptions from FERA restrictions and special incentives are almost always available for export-oriented firms.

<sup>71</sup> E.g., building, construction, and agricultural machinery, general office equipment and household goods, all consumer goods. Id.

<sup>72</sup> Subject, of course, to the exceptions for export-oriented firms.

<sup>73</sup> See, e.g., Towards A Global Society, MONTHLY COMMENTARY ON INDIAN ECON. CONDITIONS, August, 1976, at 205.

developing country.<sup>74</sup> The production of (relatively) high-priced consumer goods widens divisions between social classes, creates desires for luxury products among people too poor to afford them, and undermines important social and political objectives.<sup>75</sup> The introduction of Western consumer products is also accused of undermining traditional cultural values. Finally, the involvement of foreign firms in the production of consumer goods effectively excludes domestic competitors who are often unable to compete with the glamour of a well-publicized foreign trade-name.<sup>76</sup>

The exclusion of foreign investors from the production of consumer goods thus puts to rest one of the most common grievances associated with the unregulated operation of foreign investment in India as well as in the rest of the Third World. Foreign investment will now be allowed in this area only if 100% of the total output is exported and if the investment will not displace existing domestic enterprises.<sup>77</sup> Foreign investment in consumer goods for the domestic market may also be permitted in the rare event that domestic production cannot satisfy demand or where an infusion of updated technology is required.<sup>78</sup>

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<sup>74</sup> Making Light of Licensing, ECON. & POL. WEEKLY (Bombay), Aug. 30, 1980, at 1467, (quoting, Annual Report of Directorate General of Technical Development).

<sup>75</sup> In the case of India, the avowed purpose of achieving socialism and the reduction of social and economic disparities. See note 33 supra.

<sup>76</sup> India has addressed this problem by prohibiting the use of foreign trade-marks on goods intended for domestic consumption. See p. 75 supra.

<sup>77</sup> Conversation with Mr. Vijay Karan, Resident Director of the Indian Investment Centre, New York City (Nov. 6, 1980).

<sup>78</sup> A pending application by Gillette for a minority interest in the production of blades for the domestic market is expected to be approved on these grounds. Conversation with Mr. Vijay Karan, Resident Director of the Indian Investment Centre, New York City (Jan. 21, 1981).

## The Approval Process for Foreign Investment

Foreign investment or collaboration proposals require the approval of several different agencies. Industrial licenses are required for almost all new undertakings or expansions, domestic or foreign, under the 1951 Industries (Development and Regulation) Act and are issued by a Licensing Committee.<sup>79</sup> If the proposal contemplates the public offering of stock, permission must be obtained from the Capital Issues Committee of the Ministry of Finance. The import of equipment or machinery requires an import license under the Import and Exports (Control) Act of 1974.<sup>80</sup> Approval by the Monopolies and Restrictive Trade Practices Committee is sometimes necessary. Finally, the terms of the proposal or agreement are examined and must be approved by the Foreign Investment Board (FIB).

In the initial time period after the FERA enactment, foreign investors were required to file separate applications with each of these agencies. Complaints regarding the complexity and lengthy delays involved in this process were frequent.<sup>81</sup> In response to these complaints, the government established the Secretariat of Industrial Approvals (SIA) as a division of the Ministry of Industrial Development. Applications are now submitted to the SIA, which is responsible for forwarding them to the necessary agencies.<sup>82</sup>

The Foreign Investment Board has the final authority and overall supervision of the approval process. The FIB was established to consolidate the actions of the various agencies

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<sup>79</sup>BUS. INT'L., supra note 52, at 5.

<sup>80</sup>The government allocates the supply of foreign exchange each industrial sector will be entitled to for the coming year and issues import licenses to individual enterprises as part of its effort to conserve foreign exchange.

<sup>81</sup>BUS. INT'L., supra note 52, at 6.

<sup>82</sup>IIC Guide, supra note 41, at 38.

with regard to the treatment of applications and to speed their disposition.<sup>83</sup>

The FIB is an inter-departmental agency which consists of the Secretary of the Ministry of Finance (who acts as Chairman), the Secretary of the Planning Commission, the Director-General of the Council of Scientific and Industrial Research, the Director-General of Technical Development, and secretaries from other ministries.<sup>84</sup>

Applications are usually processed within 90 days. The SIA usually issues "letters of approval" which are valid for six months. The letter of approval will usually state any changes in the proposal or conditions which the government feels are necessary before final approval can be given.<sup>85</sup> After the financing has been arranged and the final details worked out with the Indian partner, the proposal is re-submitted for final approval.<sup>86</sup>

Investment proposals are evaluated on the basis of their compatibility with national development goals as well as with the needs of the particular industry. As may be expected, this type of evaluation involves the consideration of a number of factors.

India views foreign investment solely as a vehicle for the transfer of technology.<sup>87</sup> Proposals which include a foreign equity interest are therefore subject to closer scrutiny than mere technical collaborations.<sup>88</sup> Equity parti-

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<sup>83</sup>BUS. INT'L., supra note 52, at 6.

<sup>84</sup>Id.

<sup>85</sup>Specimen letter of approval reprinted in, IIC Guide, supra note 41, at 47-49.

<sup>86</sup>Id., at 38.

<sup>87</sup>See, pp. 73-74 supra.

<sup>88</sup>Applications for technical collaborations unaccompanied by equity participation and which involve a foreign exchange outflow of less than 5

cipation is permitted when the technology is not readily available for outright purchase or when the proposal contains a strong export commitment.<sup>89</sup>

The relative development of the industry and its need for updating technology is one of the most important factors.<sup>90</sup> The price, terms, and type of technology offered by the foreign investor are closely examined. The use of sophisticated technology, of course, increases the likelihood of approval, and may permit an equity interest of up to 74%. Proposals which include plans for the technical training of Indian employees receive favorable consideration.<sup>91</sup> The impact of the investment on existing enterprises and employment opportunities is also examined.

A major consideration in the approval process is the effect of the investment on the flow of foreign exchange. Export-oriented enterprises are strongly favored. Investments which will not require domestic financing are also preferred, although this is not of crucial importance.<sup>92</sup> Finally, applications are scrutinized for the amounts of raw materials which are expected to be used. Proposals which require large amounts of imported or scarce materials are carefully examined before approval is granted.<sup>93</sup>

Once an investment is approved, it will be treated on the

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<sup>88</sup> (continued)

million rupees may take advantage of an expedited procedure. IIC Guide, supra note 41, at 33.

<sup>89</sup> This somewhat grudging view of equity participation is due in part to the drain on foreign exchange caused by foreign ownership. See, pp. 70-71 supra.

<sup>90</sup> H. Singh, supra note 1, at 4.

<sup>91</sup> BUS. INT'L., supra note 52, at 6.

<sup>92</sup> BUS. INT'L., supra note 52, at 6.

<sup>93</sup> Id. See also, the standard application form, reprinted in, id., at 39-42 (requiring full documentation of anticipated requirements).

same basis as domestic enterprises.<sup>94</sup> There is no special post-approval regulatory, or even supervisory, framework for enterprises with foreign equity. The time limits on technical agreements<sup>95</sup> affect only the duration of the royalty and licensing provisions, not the duration of the financial investment, which may be retained indefinitely.<sup>96</sup>

New enterprises are eligible for a number of tax incentives including a five-year tax "holiday" and the use of accelerated depreciation methods.<sup>97</sup> Additional incentives are available for firms which locate in designated "backward" areas.<sup>98</sup>

### The Implementation of FERA

After the enactment of the FERA legislation, all foreign companies operating in India were ordered to convert to Indian-registered companies and to reduce foreign equity levels to 40%.<sup>99</sup> This directive was amended by the modifications of 1976 which permitted greater equity levels for firms which employed sophisticated technology or which were engaged in the production of priority items or items for export. After these amendments, all companies were given an opportunity to improve their high priority production by diversification if they

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<sup>94</sup> Singh, supra note 1, at 4.

<sup>95</sup> Five or eight years. See, p. 75 supra.

<sup>96</sup> India, unlike, e.g., the Andean countries, has no "fade-out" provisions requiring the gradual divestment of foreign equity. A strong policy against nationalization also grants stability to foreign investments.

<sup>97</sup> These are only a few of the many tax incentives available for new enterprises. For a complete listing, see, IIC Guide, supra note 41, at 23-31.

<sup>98</sup> Id., at 31.

<sup>99</sup> BUS. INT'L., supra note 52, at 8.

wished to retain their foreign majority.<sup>100</sup> Firms which refused to comply were given a reasonable amount of time in which to wind up operations.<sup>101</sup>

Although the initial response was sluggish, due to foot-dragging on both sides,<sup>102</sup> as of 1978 all 814 cases had been disposed of. Of these 814 companies, 343 were directed to reduce foreign equity to 74%, 51% or 40%.<sup>103</sup> Fifty-four other companies chose to wind up operations rather than comply. Action was considered unnecessary in 397 cases.<sup>104</sup>

Coca-Cola and IBM were among those companies which chose to end their operations in India rather than meet the reduced equity requirements. A major reason for their refusal to comply was the fear that reduced equity would impair the security of their trade secrets. Both companies offered to split their subsidiaries into two entities, one in which they would have a reduced equity interest, and one wholly-owned entity, which would guard trade secrets. These compromises were rejected.<sup>105</sup>

The reduction of foreign equity among those companies which chose to comply was usually effected through the dilution, rather than the divestment, of equity. In order to

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<sup>100</sup> Ganesan, Foreign Exchange and Investment Regulations, ECON. NEWS DIG., August, 1979 at 1. Ganesan states that:

It was only those companies which were predominantly engaged in low priority items ... and where no fresh foreign investment would even be considered today that were directed to bring down their foreign holdings to 40%. Id.

<sup>101</sup> BUS. INT'L., supra note 52, at 8.

<sup>102</sup> Chaudhuri, supra note 22, at 736.

<sup>103</sup> Id. (quoting RBI Annual Report 1977-78).

<sup>104</sup> Id.

<sup>105</sup> BUS. INT'L., supra note 52, at 8.

effectuate the process of "Indianization", the government generally required the larger companies to issue public offerings rather than private placements.<sup>106</sup> Limits were placed on the amount of shares any one individual could purchase. As a result of this process, nearly 700,000 Indian shareholders, mostly holding fewer than 100 shares, have been added to these companies.<sup>107</sup> It is evident that the government's conception of "Indianization" is not limited to the transfer of increased ownership to Indian nationals, but embraces other social objectives as well. The preference for large public offerings, which add thousands of shareholders to some corporations, attempts to effectuate a broader distribution of wealth among the population and reduce social and economic disparities.<sup>108</sup>

Companies which have reduced foreign equity to 40% are treated as "domestic" enterprises and are outside the reach of the FERA guidelines.<sup>109</sup> These companies have been accorded favorable treatment. Many of these firms, for example, have been granted new Indian licenses for diversification or have been allowed to substantially expand. The treatment of these newly-formed 40% companies as "domestic" enterprises has been criticized as a major flaw of the FERA regulations.<sup>110</sup> Domes-

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<sup>106</sup> Chaudhuri, supra note 22, at 738.

<sup>107</sup> Ganesan, supra note 99, at 1. Chaudhuri, supra note 22, criticizes the FERA legislation because it does not result in the transfer of control. He points out that Hindustan Lever, a division of Unilever, acquired 95,000 shareholders as a result of its public offering. The dispersal of shares among thousand of small investors who are generally uninterested in the management of the company leads to the result that as little as 5% equity will ensure control. Ganesan, on the other hand, who is Joint Secretary of the Dept. of Econ. Affairs, writes that the FERA guidelines were not aimed at the transfer of control. Ganesan, supra note 99, at 1.

<sup>108</sup> See, supra note 33, at 72 (discussing adoption of these aims as official government policy).

<sup>109</sup> See p. 76 supra, for the definition of "foreign enterprises" under the FERA regulations.

<sup>110</sup> Chaudhuri, supra note 22, at 740-741.



tic enterprises, unless they are very large, are not subject to the sector restrictions of the 1973 IPS.<sup>111</sup> Many companies, therefore, have used the capital generated by their public offerings to expand into sectors from which they were formerly prohibited, thereby displacing small-scale enterprises.<sup>112</sup>

The FERA regulations seem to have had little effect on the rate of foreign investment. The annual number of agreements approved rose steadily from 135 in 1969 to a high of 359 in 1974 when the FERA guidelines become effective.<sup>113</sup> After 1974, the annual figure dropped somewhat, but the average number of annual agreements for 1974-1979 has remained close to 300.<sup>114</sup> In 1979, 267 agreements were approved. Of these, 235 were technical collaborations, and 32, or about 12%, were collaborations with equity participation. The ratio of equity investments to total investments and collaborations has remained constant for the years 1969-1979, despite the many restrictions imposed by FERA on equity participation.<sup>115</sup> FERA, therefore, does not seem to have affected either the annual number of agreements or the percentage of equity investments approved.

The highest percentage of agreements approved was concluded with the United Kingdom, with the Federal Republic of Germany and the United States close behind.<sup>116</sup> Major areas of

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<sup>111</sup> See pp. 78 & 79 supra.

<sup>112</sup> Chaudhuri, supra note 22, at 740-741. An example of this is the expansion of Colgate-Palmolive into the production of menthol, an industry characterized by a large number of small units. Id. at 741.

<sup>113</sup> Indian Economy At A Glance, Table XII (pamphlet of the Indian Investment Centre, 1980). See also, H. Singh, supra note 1 at 6.

<sup>114</sup> Indian Economy At A Glance, supra note 110, at Table XII.

<sup>115</sup> Id.

<sup>116</sup> ECON. NEWS DIGEST, April-May, 1980, at 7 (Indian Investment Centre, New York).

investment were industrial machinery, electrical equipment, transportation, chemicals, industrial instruments, and the metallurgical industries.<sup>117</sup>

### CONCLUSION

The FERA regulations appear well-designed for the purpose of achieving the compatibility of foreign investment with developmental goals. Whether the regulations actually affect progress towards these goals, however, cannot be answered without further study.

It is notable that FERA does not address the problem of unemployment and its increase through the adoption of capital-intensive production methods. India's industrialization program requires a massive transfer and adoption of new technologies. The demands of industrialization ensure that investment proposals which can bring sophisticated technology into India will meet with quick approval. The effect of foreign investment on employment is cited as a factor in the evaluation process of new proposals. The FERA regulations, however, provide no guidelines for determining the balance between the capital-intensive production methods required for industrialization and the need to generate employment opportunities for a largely unskilled population.

The increased participation of Indian nationals in corporate ownership seems to have been achieved by the application of FERA to existing companies. Increased corporate ownership by Indians probably will not, in itself, lead to greater consideration of local needs in the determination of business policy. Other parts of the FERA framework, notably the confinement of investment to "core" sectors and the rigid scrutiny of technological agreements, may, however, be sufficient to correct the worst abuses of foreign ownership.

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<sup>117</sup> Id.

In retrospect, the enactment of FERA, despite the many restrictions it imposes, does not appear to be a disincentive to investment in India.<sup>118</sup> Further study of investor reactions to the FERA regulations is required in order to more fully evaluate this aspect of the regulations. In particular, the problem of protecting trade secrets in a collaborative venture merits further examination.

In conclusion it should be noted that, despite the many changes introduced by India's new foreign investment policy, the foundations of that policy, established by Nehru in 1949, have remained unchanged. Foreign investment, once approved, continues to receive equal treatment with Indian companies; full repatriation of profits and capital is still allowed;<sup>119</sup> and the strong policy against nationalization has been maintained. The protection of national interests, the key principle of the Nehru policy, remains the guiding force of India's new foreign investment policy.

Yvonne Miller

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<sup>118</sup> See, pp. 88 supra.

<sup>119</sup> H. Singh, supra note 1, at 10.